Euler Hermes Economic Research

Country Report

Turkey

From slowdown to renewed upswing

General Information

GDP	USD789 bn (World ranking 17, World Bank 2012)
Population	74 mn (World ranking 18, World Bank 2012)
Form of state	Republican Parliamentary Democracy
Head of government	PM Ahmet DAVUTOGLU (AKP)
Next elections	June 2015, legislative

Strengths

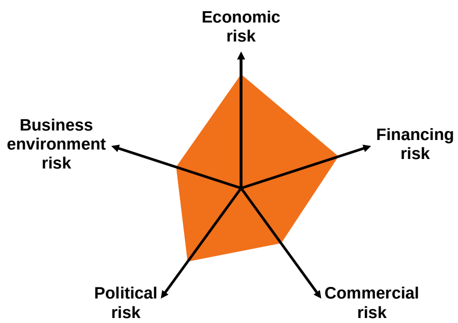
- Important geostrategic position that has historically always ensured aid when needed
- Public finances
- Adequate business environment
- Well-educated workforce and competitive economy
- Mostly financially solid banking sector
- Increasingly important role as regional hub between Europe, MENA and Asia

Weaknesses

- Continued rapid private sector credit growth
- Exchange rate vulnerability to domestic and external shocks
- Economic policy responsiveness
- Persistently large current account deficits, largely financed through short-term external debt which has consequently rapidly risen
- (External) debt refinancing risk of weaker companies and banks
- Deep-rooted division in society between secularists and religious conservatives
- Geopolitical risks

Country Rating

C3



Source: Euler Hermes

Trade Structure

By destination/origin (% of total)

Exports		Rank		Imports
Germany	10%	1	11%	Russia
Iraq	7%	2	10%	China
United Kingdom	6%	3	9%	Germany
Italy	5%	4	5%	United States
France	4%	5	5%	Italy

By product (% of total)

Exports		Rank		Imports
Road vehicles	11%	1	11%	Machinery and equipment
Clothing	11%	2	8%	Chemicals
Foodstuff	9%	3	8%	Basic metals
Basic metals	9%	4	7%	Petroleum and products thereof
Textiles	8%	5	6%	Road vehicles

Source: Turkstat

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Lower energy prices to boost growth in 2015

Real GDP growth decelerated in y/y terms to +1.7% in Q3 2014, down from +2.2% in Q2 and +4.8% in Q1. Private consumption and investment as well as imports have remained soft as compared to 2013, dampened by a weaker exchange rate and higher interest rates. However, in q/q, sa terms real GDP growth recovered to +0.4% in Q3, after contracting by -0.5% in Q2, thanks to a rebound in domestic demand which had declined in H1 as a result of monetary tightening (which has been relaxed somewhat since May 2014). Private consumption expanded by +1.7% q/q in Q3, government consumption by +2.1% q/q and fixed investment by +1.9% q/q. Net exports also made a positive contribution to Q3 growth as imports contracted markedly by -3.1% q/q while exports increased by +0.6% q/q. Going forward, a more stable exchange rate and lower global oil prices should support economic activity. Euler Hermes forecasts full-year GDP growth of +2.8% in 2014, followed by around +4.3% in 2015.

Monetary policy appears too loose to contain inflation pressures and currency volatility

At end-January 2014, the Central Bank of Turkey (CBT) returned to orthodox monetary policy, hiking its key policy interest rate by 550bps to 10%. The decisive but belated move was a response to recurrent financial market turbulences over the previous year, which had exposed once again the vulnerabilities associated with large current account deficits predominantly financed through short-term capital inflows, especially when combined with political turmoil and sluggish policy responsiveness. The Turkish lira (TRY) had depreciated by over 30% against a USD-EUR basket from May 2013 to January 2014, pushing up inflation to 7.8% y/y. At the same time, private sector credit growth had surged to an unsustainable 37% y/y in January. By May 2014, as a result of the interest rate hike, the TRY re-gained about 10% and credit growth slowed to 23% y/y, but inflation continued to rise to 9.7% y/y. Nonetheless, upon some political pressure the CBT lowered its key policy rate again by a cumulative 175bps in May-July to 8.25%. Meanwhile, the TRY has weakened again against the USD (about 1:2.26 on December 9, same as end-January) and the EUR (1:2.80 on December 9, about 10% stronger than at end-January). Credit growth has re-surged to 28% y/y in September 2014. The weaker exchange rate has kept inflation elevated, at 9.2% y/y in November, and Euler Hermes expects it to remain above the CBR's inflation target range of 3%-7% for most of 2015.

Further monetary policy loosening could once again increase the TRY's vulnerability to a fresh sell-off, especially against the background of forthcoming legislative elections in June 2015 and still large current account shortfalls. After all, the exchange rate of the TRY has shown considerable volatility and vulnerability to external and domestic shocks in recent years. Currency risk remains a concern in the medium term, especially since short-term foreign capital inflows have remained substantial to date.

Adequate public finances

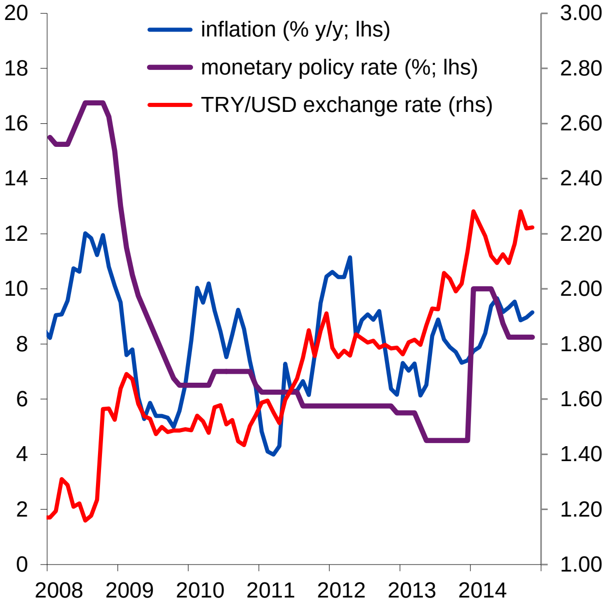
Turkey's fiscal position has markedly improved since the domestic economic crisis in 2001. The annual fiscal deficit has been below 3% of GDP since 2011 and should come in at around 2% of GDP in 2014-2015. Total public debt in relation to GDP has more than halved from almost 80% in 2001 to around 36% in 2013. Fitch Ratings agency upgraded Turkey to investment grade in November 2012, followed by Moody's in May 2013. S&P has kept the country one notch below that level, for now.

Key economic forecasts

	2012	2013	2014f	2015f
GDP growth (% change)	2.1	4.1	2.8	4.3
Inflation (%, end-year)	6.2	7.4	9.0	7.0
Fiscal balance (% of GDP)	-1.4	-1.5	-2.3	-2.2
Public debt (% of GDP)	36.2	36.3	35.2	34.5
Current account (% of GDP)	-6.1	-7.9	-5.0	-5.5
External debt (% of GDP)	42.7	53.1	52.5	52.0

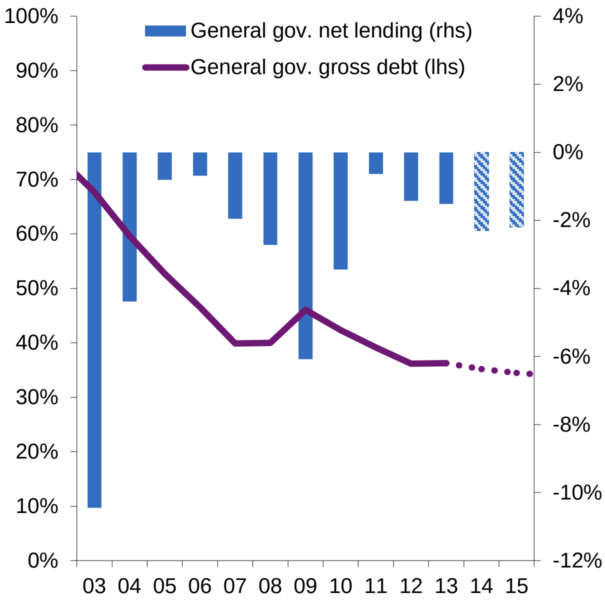
Sources: National sources, IHS, Euler Hermes

Monetary policy interest rate (%), inflation rate (y/y, %), and exchange rate



Sources: National sources, IHS, Euler Hermes

Public finances (% of GDP)



Sources: IMF, Euler Hermes

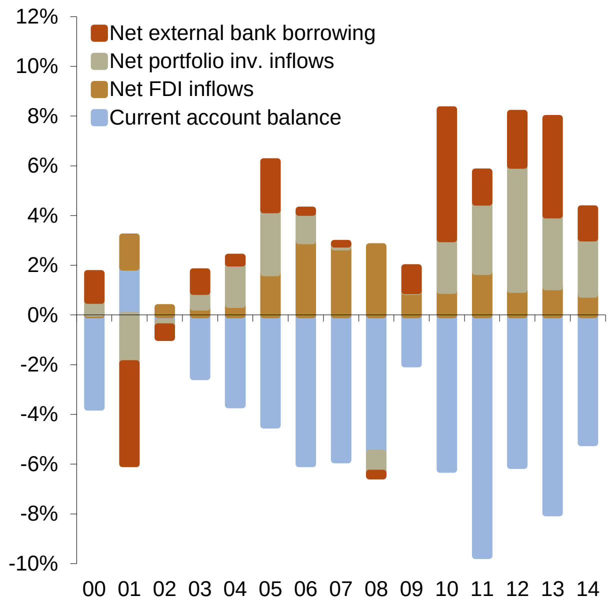
Current account deficit has narrowed somewhat ...

The current account deficit increased from USD48.5 bn (-6.1% of GDP) in 2012 to USD65.1 bn (-7.9% of GDP) in 2013, as the terms of trade deteriorated. Meanwhile, as a result of the markedly weaker TRY in 2014 and the ensuing import moderation, the current account deficit has declined, amounting to USD30.9 bn in the first nine months of 2014, down -37% y/y. Euler Hermes forecasts the annual shortfall to narrow to a still worrisome ratio of about -5% of GDP in 2014 before rising slightly to -5.5% in 2015.

...but the financing of the deficit remains a cause of concern

Net foreign direct investment (FDI) inflows have been modest in recent years (USD4.9 bn or 0.8% of GDP in Q1-Q3 2014), covering just 16% of the cumulative current account deficit in 2010-2014. The large remainder of the shortfall was financed through new short-term external debt: In Q1-Q3 2014, net portfolio investment inflows, which have a more speculative nature, amounted to USD13.6 bn (2.3% of GDP). Net external bank borrowing, however, has moderated to USD7.2 bn (1.2% of GDP) in Q1-Q3 2014, down from USD32 bn (3.9% of GDP) in 2013.

Current account and financing of deficits (% of GDP)



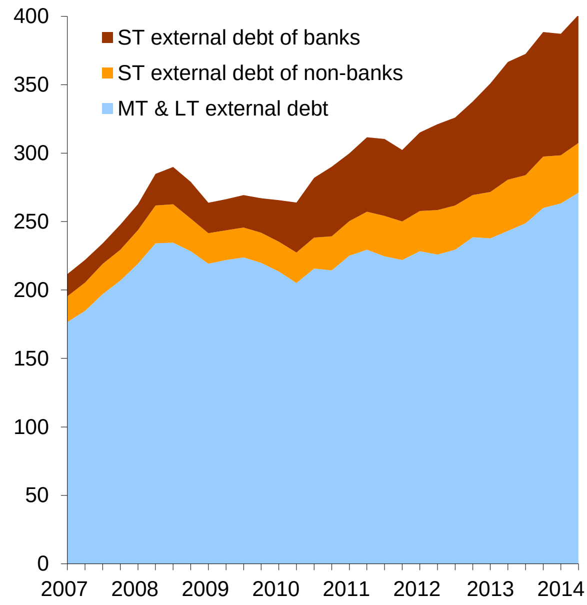
Note: 2014 data refer to Q1-Q3 2014.

Sources: National sources, IHS, Euler Hermes

Rapidly rising short-term external debt poses risks and requires close monitoring

As a result, total external debt has risen to a record USD402 bn in mid-2014, up from USD339 bn at end-2012. Moreover, owing to the TRY depreciation in 2013-2014, the ratio of external debt to GDP (53%) or export earnings (185%) has sharply increased since end-2012 (43% and 164%, respectively). Furthermore, short-term external debt has risen faster than the total, hitting a worrisome, new record high of USD131 bn in Q3 2014 and increasing to about 33% of the total from 17% at end-2007. The debt-service ratio has fallen but will remain elevated at about 20% in 2015.

External debt (USD bn)



Sources: Central Bank of Turkey, Euler Hermes

Foreign exchange reserves appear adequate

Owing to central bank intervention to stabilise the TRY and partial reversals of earlier capital inflows, foreign exchange reserves fell from a record USD114 bn in April 2013 to a temporary low of USD105 bn in July 2013 and again in January 2014 – reflecting Turkey's ongoing vulnerability to external and political events. Meanwhile, reserves have recovered to USD113 bn in October 2014. Positively, the current level of foreign exchange reserves is comfortable with regard to import cover (around five months). In other terms, however, reserves cover just about 68% of the estimated external debt payments falling due in the next 12 months, which is well below a comfortable level of at least 100%.

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